DAVIDSON capital advisors, LLC

US Economics and Rate Strategy

January 14, 2020

US Economics & Rates Strategy

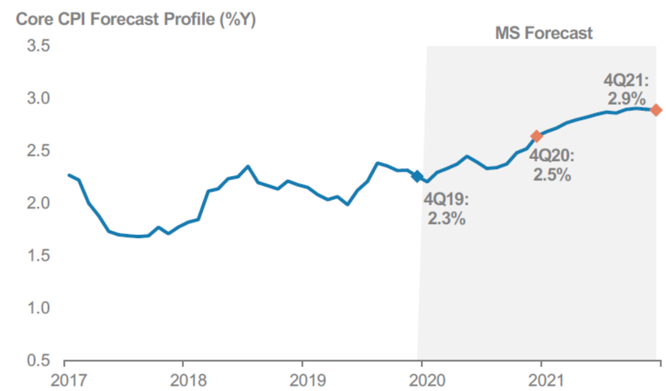
US Economics: Accounting for Downside Surprises

Core CPI surprised somewhat to the downside and rose 0.1%M (0.113%M unrounded) in December, keeping the year-over-year rate at 2.3%Y. However, core unrounded printed at 2.259%, i.e., not far from rounding down to 2.2%Y. With food prices up 0.2%M and energy up 1.4%M, headline CPI moved up 0.2%M (0.219%M unrounded), which lifted the year-over-year rate from 2.1%Y to 2.3%Y. The underlying details were mixed. Core services decelerated from +0.27%M in November to +0.18%M in December, matching the monthly reading last seen in May 2019. Core goods moved down on the month, coming in at -0.04%M.

With the latest underwhelming inflation prints in mind, economists compare their projected core PCE path in their latest US economics outlook with a marked-to-market update for the latest available data. All else equal, their marked-to-market projections show a shallower path for the first three quarters of 20, while the 4Q/4Q forecast in 2020 for core PCE remains broadly unchanged at 2.2%Y (unrounded at 2.18%Y). Notably, their forecast remains significantly above the latest projections by the FOMC, released in December 2019 (Exhibit 2 & Exhibit 3). The 4Q/4Q projection in 2020 for core CPI fell from 2.6%Y to 2.5%Y.

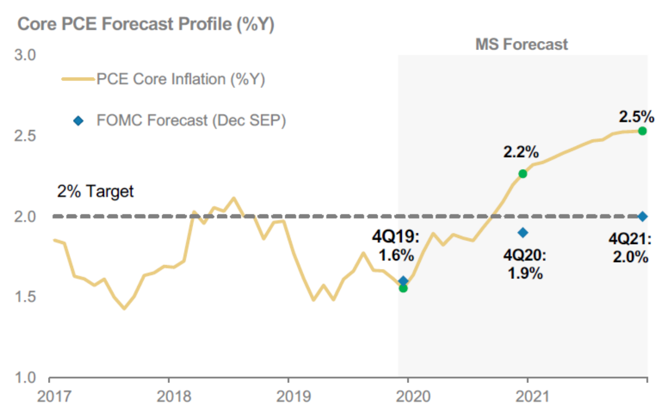
That said, implications for the Fed from the December CPI and projected PCE inflation prints should be minimal. Economists continue to see the Fed on hold through next year. On their current year-ahead forecasts for inflation, the bar for hiking rates will not be met prior to the third quarter of 2021. At the same time, the FOMC plans to revisit the inflation framework in the context of the general framework review, and officials are pointing to a likely completion around the middle of 2020. This would put it on track to release the statement at the June FOMC meeting and may include a change to the inflation framework.

Exhibit 2: Core CPI: Marking to Market



Source: Bureau of Labor Statistics, Morgan Stanley Research

Exhibit 3: Core PCE: Marking to Market



Source: Bureau of Economic Analysis, Morgan Stanley Research

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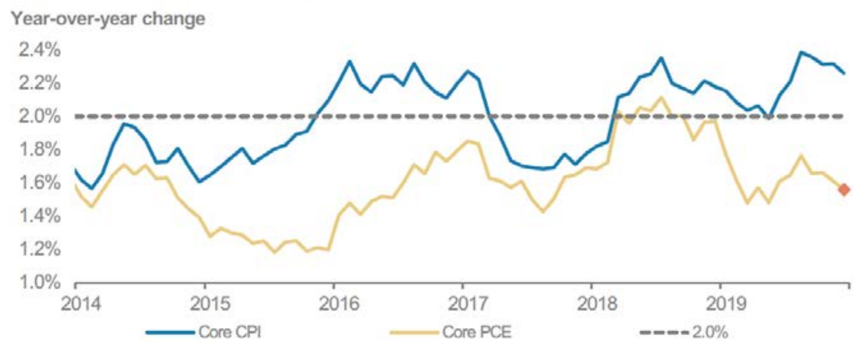
Translating CPI into PCE: Incorporating the CPI inputs, economists preliminary forecast for December core PCE inflation is 0.12%M, keeping the year-over-year rate at 1.6%Y (1.61%Y vs. 1.56%Y). Headline PCE inflation should move up 0.17%M on the month, which would result in the year-over-year rate moving up from 1.5%Y to 1.6%Y (1.47%Y vs. 1.59%Y) (Exhibit 4 & Exhibit 5).

Exhibit 4: Core PCE vs Core CPI Trajectory



Source: Note: Red marker represents MS forecasts; Source: BEA, BLS, Morgan Stanley Research

Exhibit 5: Translating CPI into PCE

	%Month/Month		Weight in:		Contribution to:	
	CPI	PCE*	core CPI	core PCE	core CPI	core PCE*
Core Goods	-0.04	-0.15	24%	24%	-0.01	-0.04
Rent & OER	0.24	0.24	41%	19%	0.10	0.04
Medical Services	0.35	-0.08	9%	19%	0.03	-0.01
Core-Core Services	0.03	0.23	26%	38%	0.01	0.09

*Note: PCE growth rates and contributions are estimated; Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Morgan Stanley Research

US Rates Strategy

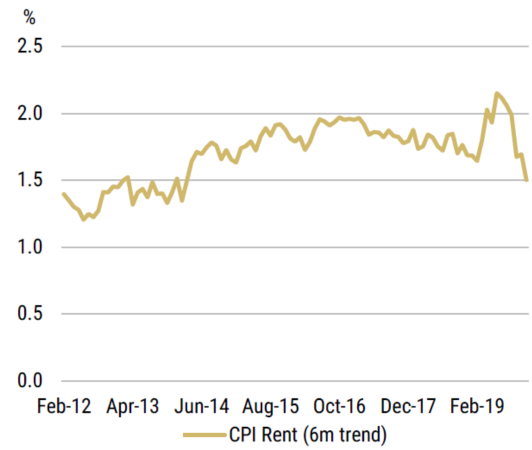
Three things are notable: (1) rent and OER inflation is slowing more decisively than in the past (Exhibit 6); (2) tariff effects – which drove a lot of the recent upside in the non- Phillips curve sensitive components – saw sharp declines in December, reversing the core CPI trend, while Phillips curve components continue to languish (Exhibit 7); and (3) healthcare insurance still adding ~20bp to core CPI, where doubts on sustainability remain.

Rent inflation slowing decisively: The 6m annualized trend in rent (OER) inflation is 3.03% (2.84%), the lowest 6m trend since mid-2014 (mid-2017) – see Exhibit 6. Class B rent inflation has been driving the recent decline. Across the regions, the decline is broad based over the past year. In December in particular, all of the decline in rent and OER came from the Northeast, while other regions were stable.

Tariff effects washing out: December was the first month when the Phase 1 deal looked like a distinct possibility – and saw many of recent tariff-affected categories decline. For example, the biggest downside move in December CPI came from major appliances (-3.01%M). Other notable declines were furniture (-0.58%M), household equipment (- 1.11%M), and photography equipment (-2.18%M). Some tariff-affected categories continue strong, such as pet products (0.26%M), women's apparel (+1.28%M) and other appliances (+1.09%M).

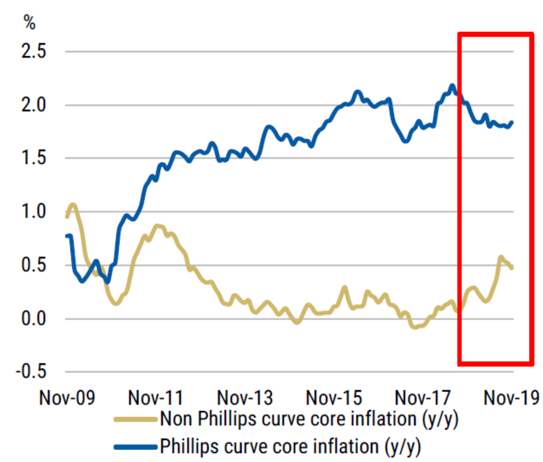
Healthcare insurance still strong: On a m/m basis, healthcare insurance inflation (+1.48%M) saw another strong print, keeping the rate at an elevated 20.4%Y. This category has contributed ~20bp to core CPI over the last year – and has proved amazingly resilient. Economists continue to believe this pace is unsustainable.

Exhibit 6: 6m trend in rent inflation over the last 10 years



Source: Bloomberg, Morgan Stanley Research

Exhibit 7: Moves in Phillips curve vs. non-Phillips curve components over the last 10 years



Source: Bloomberg, Morgan Stanley Research

CPI breakdown details

Core Services (+0.18%M) weakened this month vs. its recent trend. Core services have annualized at a healthy but uninspiring 2.83% over the past three months, vs. a 12m rate of 2.97%.

- Shelter (+0.18%M) was a weak in December, with a reversal of the hotel price strength in November. Within rent and OER, as noted above, the trend has been weakening substantially.
- Healthcare services (+0.35%M) was strong again – keeping in line with the decent trend in the last 6-12 months. While hospital services (+0.21%M) led the increase in November, healthcare insurance cost has been rising rapidly for the last year (20.4%Y) – the upside may be reflecting significant rebates, and/or a change in methodology. In general, economists think healthcare inflation will be decent in the next two years.
- Core core services (+0.12%M) – another Phillips curve sensitive category – rose modestly in December. Transportation services were weak – led by airfares, but also intercity transportation. The 1y trend in this category is still a modest +1.74%Y.

Exhibit 8: December CPI breakdown into major components

Category	Weight	Dec 19 m/m (%)	Nov 19 m/m (%)	Oct 19 m/m (%)	1 Year (%)	6m annualized (%)	3m annualized (%)	1m annualized (%)
CPI NSA	100.0	-0.09	-0.05	0.23	2.29	0.65	0.34	-1.09
CPI	100.0	0.22	0.26	0.36	2.29	2.52	3.39	2.66
Food	13.3	0.16	0.12	0.24	1.81	1.40	2.13	1.94
Energy	7.5	1.42	0.80	2.70	3.53	5.92	21.54	18.50
Core CPI	79.2	0.11	0.23	0.16	2.25	2.39	2.02	1.37
Core Services	59.9	0.18	0.27	0.24	2.97	3.11	2.83	2.19
Shelter	33.4	0.18	0.26	0.05	3.23	2.54	2.00	2.17
Rent	8.0	0.23	0.26	0.14	3.69	3.03	2.55	2.85
OER	24.1	0.24	0.24	0.18	3.28	2.84	2.69	2.95
Out of town lodging	0.9	-1.75	1.09	-3.84	-0.28	-7.14	-16.81	-19.09
Medical care services	7.1	0.35	0.38	0.90	5.09	7.00	6.73	4.32
Services (ex-Shelter, ex-healthcare)	19.4	0.12	0.26	0.33	1.74	2.66	2.82	1.45
Transportation services	5.9	-0.26	-0.01	0.08	0.59	1.64	-0.76	-3.11
Recreation Services	3.9	0.48	0.57	0.89	2.67	5.45	8.04	5.88
Education Services	6.0	0.16	0.36	0.22	2.01	1.83	2.98	1.93
Other services	1.6	0.39	0.22	0.19	1.84	3.45	3.22	4.73
Core commodities	19.3	-0.04	0.04	-0.09	0.04	0.18	-0.35	-0.47
Household furnishings	3.3	-0.32	-0.11	-0.35	0.32	-0.62	-3.05	-3.73
Apparel	3.0	0.40	0.13	-1.77	-1.19	-1.93	-4.87	4.96
Transportation commodities less fuel	6.5	-0.20	0.17	0.37	-0.12	0.43	1.39	-2.33
Medical care commodities	1.7	1.48	0.07	1.22	2.47	5.48	11.65	19.25
Recreational commodities	1.8	-0.58	0.08	0.42	-0.93	-0.27	-0.35	-6.73
Education and comm	0.5	-1.15	-0.13	-1.94	-5.97	-4.72	-12.17	-12.97
Alcoholic beverages	1.0	0.12	-0.29	-0.25	0.49	-0.34	-1.66	1.49
Other goods	1.6	-0.52	0.31	0.23	2.84	2.59	0.07	-6.07

Source: Haver, Morgan Stanley Research

Core goods (-0.04%M) was back in negative territory as a lot of tariff-affected goods reversed their strength. The 1y trend in core goods is essentially zero (+0.04%M).

- Apparel (0.40%M) was better for the second consecutive month, marking a slight reversal after two weak months, in September and October.
- Household furnishing (-0.32%M) was weak in December, reflecting some reversal of tariff-led gains in recent months (major appliances, household equipment, furniture), but also continued strength in some other tariff-affected categories (other appliances).

- Drug prices (+1.48%M) was the biggest (and only) bright spot in core goods prices, and keeping in line with the strength in recent months. Recreational commodities (-0.58%M) were weak as well – led by declines in sporting goods (-0.83%M) and photography equipment (-2.18%M). Education commodities (-1.94%M) was very weak in December – and has seen a significant drop in the prices of software, phones and PCs (-1.60%M).
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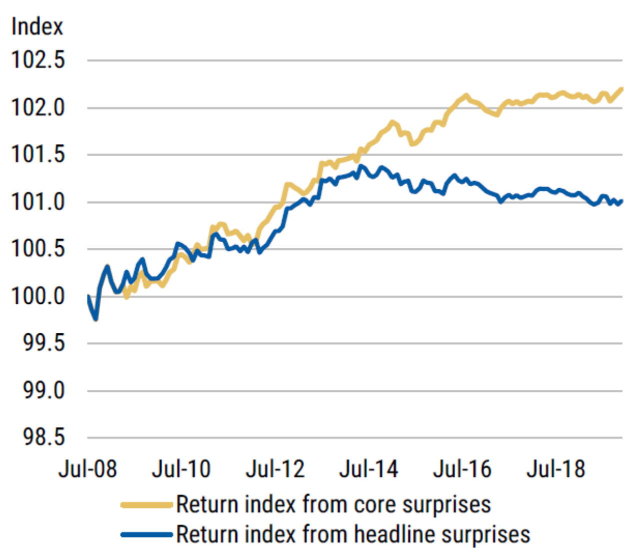
Inflation Strategy: Staying neutral

Given the trend in core CPI in the last 3- and 6-month CPI prints, economists see no major reason to move away from their neutral stance on breakevens. The market reaction post CPI suggests that the market was disappointed with the downside print. As economists show in Exhibit 9, a systematic strategy positioning in 5-year breakevens, in the direction of the surprise, has not done well over the last few years – suggesting markets have treated inflation surprises as short-term updates, with no follow-up in the next few days. And therefore economists do not expect a major follow-up in breakevens from the latest print.

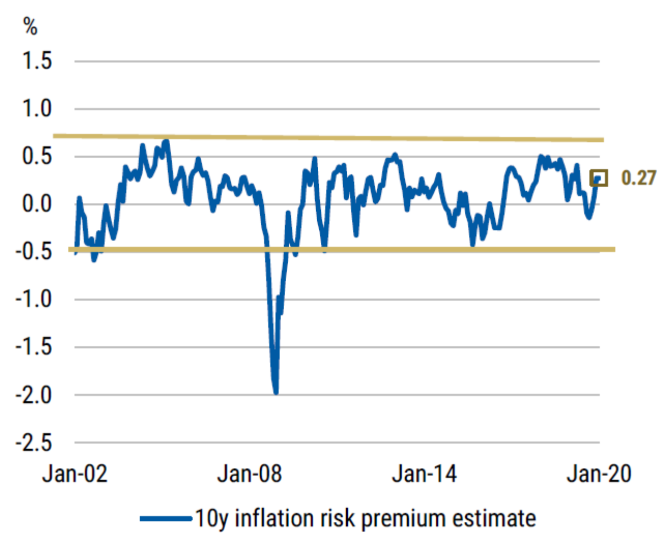
In terms of breakeven valuations as they stand, inflation risk premiums have been rising lately, as inflation expectations measured in long-term inflation surveys have been moving lower. At current levels, inflation risk premiums embedded in 10-year breakevens are in the higher end of the range, suggesting inflation breakevens are on the richer side (see Exhibit 10).

Exhibit 9: Systematic trading strategy based on CPI surprises and 5-year breakevens



Source: Bloomberg, Morgan Stanley Research

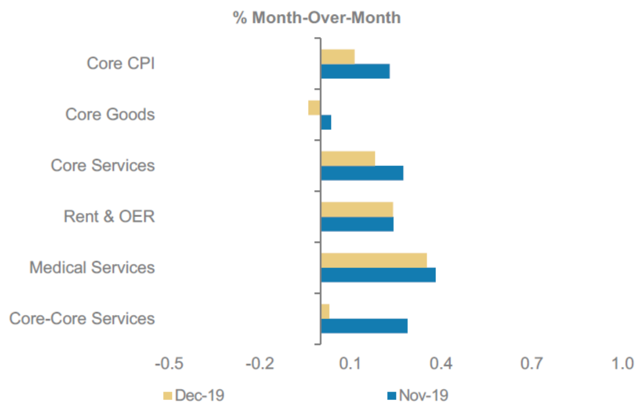
Exhibit 10: Inflation risk premiums embedded in the 10-year breakeven



Source: Bloomberg, Morgan Stanley Research

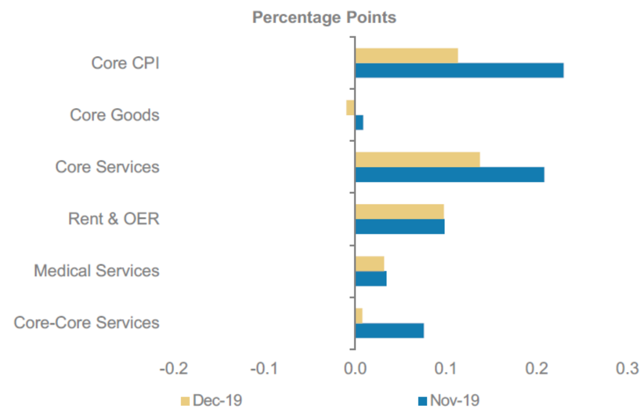
Top Charts

Exhibit 11: Month-Over-Month Growth in Core CPI Components



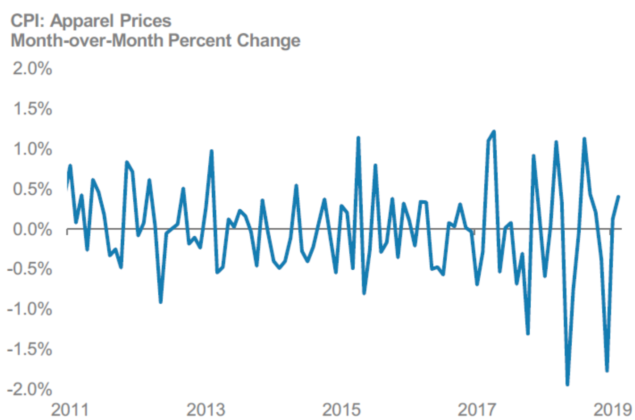
Source: Bureau of Labor Statistics, Morgan Stanley Research

Exhibit 12: Contributions to Month-Over-Month Growth in Core CPI



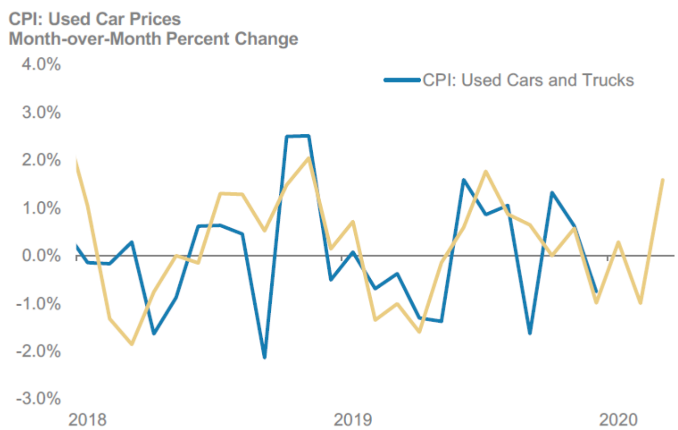
Source: Bureau of Labor Statistics, Morgan Stanley Research

Exhibit 13: Month-Over-Month Growth in Apparel Prices



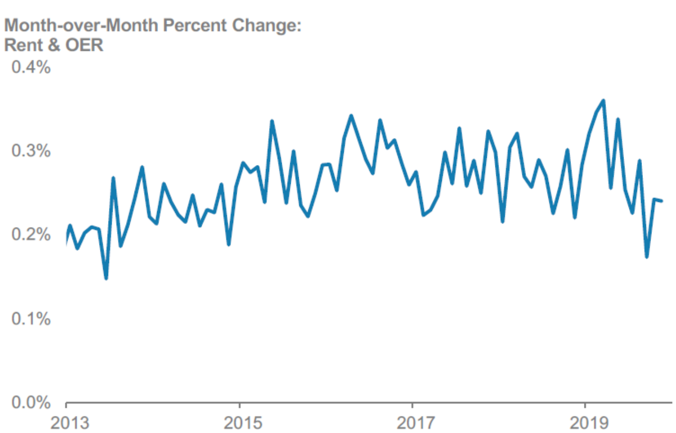
Source: Bureau of Labor Statistics, Morgan Stanley Research

Exhibit 14: Month-Over-Month Growth in Used Vehicles Prices



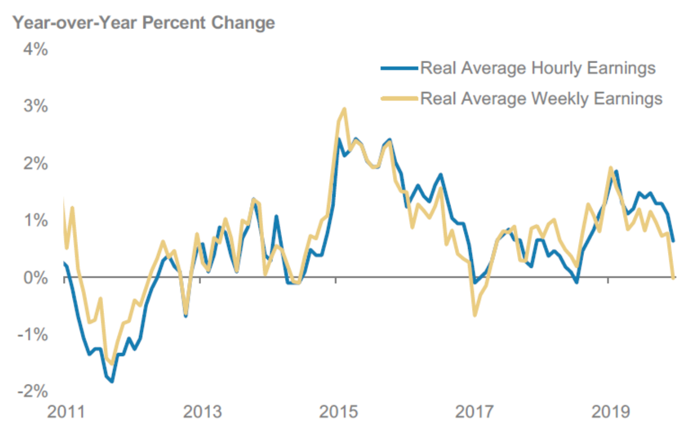
Source: Bureau of Labor Statistics, Morgan Stanley Research

Exhibit 15: Month-Over-Month Growth in Rent and OER Prices



Source: Bureau of Labor Statistics, Morgan Stanley Research

Exhibit 16: Real Average Hourly Earnings



Source: Bureau of Labor Statistics, Morgan Stanley Research.